

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING #95-27**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Whether [THE TAXPAYER], under the facts set forth in eight (8) different scenarios, would be required to include sales to an out-of-state customer in the sales factor numerator of its apportionment formula for Tennessee corporate franchise, excise tax purposes.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only.

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and

(E) The taxpayer directly involved must have acted in good faith in relying upon the ruling and a retroactive revocation of the ruling must inure to his detriment.

FACTS

Fact Scenario 1. [THE TAXPAYER] is a Tennessee vendor which sells tangible personal property to an out-of-state customer who is not the U.S. government. The goods are shipped by common carrier from [THE TAXPAYER]'s Tennessee warehouse to the purchaser at an out-of-state destination. This is not a drop shipment to a third party. The goods are shipped F.O.B. shipping point and the customer bears all risk of loss or damage in transit.

Fact Scenario 2. [THE TAXPAYER] is a Tennessee vendor which sells tangible personal property to an out-of-state customer who is not the U.S. government. The goods are shipped by common carrier from [THE TAXPAYER]'s Tennessee warehouse to the purchaser at an out-of-state destination. This is not a drop shipment to a third party. The out-of-state customer arranges and pays for shipment by the common carrier. The goods are shipped F.O.B. shipping point, but [THE TAXPAYER] bears all risk of loss or damage in transit.

Fact Scenario 3. [THE TAXPAYER] is a Tennessee vendor which sells tangible personal property to an out-of-state customer who is not the U.S. government. The goods are shipped by common carrier from [THE TAXPAYER]'s Tennessee warehouse to the purchaser at an out-of-state destination. This is not a drop shipment to a third party. [THE TAXPAYER] arranges for shipment by the common carrier. However, the common carrier bills the customer directly for the shipment and the customer is responsible for payment. The goods are shipped F.O.B. shipping point and the customer bears all risk of loss or damage in transit.

Fact Scenario 4. [THE TAXPAYER] is a Tennessee vendor which sells tangible personal property to an out-of-state customer who is not the U.S. government. The goods are shipped by common carrier from [THE TAXPAYER]'s Tennessee warehouse to the purchaser at an out-of-state destination. This is not a drop shipment to a third party. [THE TAXPAYER] arranges for shipment by the common carrier. However, the common carrier bills the customer directly for the shipment and the customer is responsible for payment. The goods are shipped F.O.B. shipping point, but [THE TAXPAYER] bears all risk of loss or damage in transit.

Fact Scenario 5. [THE TAXPAYER] is a Tennessee vendor which sells tangible personal property to an out-of-state customer who is not the U.S. government. The goods are shipped by common carrier from [THE TAXPAYER]'s Tennessee warehouse to the purchaser at an out-of-state destination. This is not a drop shipment to a third party. The

out-of-state customer arranges for shipment by the common carrier. However, [THE TAXPAYER] is responsible for payment to the common carrier. The goods are shipped F.O.B. shipping point, but [THE TAXPAYER] bears all risk of loss or damage in transit. The price of the goods excludes transportation costs but the customer is billed separately by [THE TAXPAYER] for the cost of transportation.

Fact Scenario 6. [THE TAXPAYER] is a Tennessee vendor which sells tangible personal property to an out-of-state customer who is not the U.S. government. The goods are shipped by common carrier from [THE TAXPAYER]'s Tennessee warehouse to the purchaser at an out-of-state destination. This is not a drop shipment to a third party. The out-of-state customer arranges for shipment by the common carrier. However, [THE TAXPAYER] is responsible for payment to the common carrier. The goods are shipped F.O.B. shipping point and the customer bears all risk of loss or damage in transit. The price of the goods excludes transportation costs but the customer is billed separately by [THE TAXPAYER] for the cost of transportation.

Fact Scenario 7. [THE TAXPAYER] is a Tennessee vendor which sells tangible personal property to an out-of-state customer who is not the U.S. government. The goods are shipped by common carrier from [THE TAXPAYER]'s Tennessee warehouse to the purchaser at an out-of-state destination. This is not a drop shipment to a third party. [THE TAXPAYER] arranges and pays for shipment by the common carrier. The goods are shipped F.O.B. shipping point and the customer bears all risk of loss or damage in transit. The price of the goods excludes transportation costs but the customer is billed separately by [THE TAXPAYER] for the cost of transportation.

Fact Scenario 8. [THE TAXPAYER] is a Tennessee vendor which sells tangible personal property to an out-of-state customer who is not the U.S. government. The goods are shipped by common carrier from [THE TAXPAYER]'s Tennessee warehouse to the purchaser at an out-of-state destination. This is not a drop shipment to a third party. [THE TAXPAYER] arranges and pays for shipment by the common carrier. The goods are shipped F.O.B. shipping point, but [THE TAXPAYER] bears all risk of loss or damage in transit. The price of the goods excludes transportation costs but the customer is billed separately by [THE TAXPAYER] for the cost of transportation.

QUESTION

In each of the eight fact scenarios set forth above, would [THE TAXPAYER] be required to include the described sale in its sales factor numerator for Tennessee corporate franchise or excise tax apportionment formula purposes?

RULING

No.

ANALYSIS

TENNESSEE LAW AND FRANCHISE EXCISE TAX RULES

T.C.A. § 67-4-811(g)(1) and (h)(1) provides as follows with regard to inclusion of sales of tangible personal property in the apportionment formula for corporate excise tax purposes. T.C.A. § 67-4-910(g)(1) and (h)(1) sets forth the same requirements for corporate franchise tax purposes.

“(g)(1) The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.”

“(h) Sales of tangible personal property are in this state if:

(1) The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the F.O.B. point or other conditions of the sale; . . .”

Departmental Rule 1320-6-1-.33(1)(a) through (d), including examples, contains the following provisions with regard to sales of tangible personal property and the Tennessee apportionment sales factor numerator.

(a) Gross receipts from the sales of tangible personal property (except sales to the United States Government; see Rule 1320-6-1-.33(2)) are in this state if the property is delivered or shipped to a purchaser within this state regardless of the F.O.B. point or other conditions of sale.

(b) Property shall be deemed to be delivered or shipped to a purchaser within this state if the recipient is located in this state, even though the property is ordered from outside this state.

Example: The taxpayer, with inventory in State A sold \$100,000 of its products to a purchaser having branch stores in several states including this state. The order for the purchases was placed by the purchaser's central purchasing department located in State B. Twenty-five thousand dollars (\$25,000) of the purchase order was shipped directly to purchaser's branch store in this state. The branch store in this state is the “purchaser within this state” with respect to \$25,000 of the taxpayer's sales.

(c) Property is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.

Example: The taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of taxpayer's products shipped to the purchaser's warehouse in this state is property "delivered or shipped to a purchaser within this state."

(d) The term "purchaser within this state" shall include the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state.

Example: A taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in this state pursuant to purchaser's instructions. The sale by the taxpayer is "in this state."

(e) When property being shipped by a seller from the state of origin to a consignee in another state is diverted while enroute to a purchaser in this state, the sales are in this state.

Example: The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While enroute the produce is delivered to the purchaser's place of business in this state in which state the taxpayer is subject to tax. The sale by the taxpayer is attributed to this state.

The language in T.C.A. § 67-4-811(h)(1) is taken directly from Section 16(a) of the Uniform Division of Income for Tax Purposes Act (UDITPA) and Departmental Rule 1320-6-1-.33 and its examples contain language similar to Multistate Tax Compact (MTC) Regulations. UDITPA is a model act drafted by the National Conference of Commissioners on Uniform State Laws and approved at their 66th Annual Conference in July, 1957. It was intended to reduce diversity among states in allocation and apportionment methods used to determine their respective shares of a corporation's taxable income.

Currently, UDITPA, or UDITPA like statutes, have been adopted by the majority of states imposing a corporate income tax. *Multistate Corporate Income Tax Guide*, (CCH) paragraphs 145 and 401 (1994). The Multistate Tax Compact created the Multistate Tax Commission in the interest of uniform corporate income taxation. Member states may subscribe to the Compact and its joint audit program. The Compact adopts UDITPA as an optional method of apportionment by member states. Currently there are 17 member states and the District of Columbia. Twenty-four other states have adopted some of the MTC regulations or have similar provisions. *Id.* Tennessee is not a member of the

Multistate Tax Compact, but is an associate member of the Compact and has adopted rules similar to the Compact's Rules on UDITPA Allocation and Apportionment. *Id.* at paragraphs 426 and 4162.01.

In T.C.A. § 67-4-804(b) Tennessee has declared that, with regard to business and nonbusiness earnings, its law implements UDITPA as generally interpreted by states adopting the act. In 1976 Tennessee adopted apportionment provisions similar to UDITPA for corporate franchise, excise tax purposes. *Id.* at paragraph 4162.01.

RECEIPTS FROM SALE OF TANGIBLE
PERSONAL PROPERTY ARE ATTRIBUTED
TO TENNESSEE BY USE OF THE "DESTINATION TEST"

T.C.A. § 67-4-811(h)(1) and Departmental Rule 1320-6-1-.33(1)(a) provide that, for purposes of the sales factor of the apportionment formula, sales of tangible personal property are Tennessee sales if the property is delivered or shipped to a purchaser within Tennessee and that the F.O.B. point or other conditions of the sale are not determinative in this regard. There are no Tennessee court decisions under current law concerning attribution of sales for purposes of the franchise, excise tax apportionment formula receipts factor. There is one unpublished Tennessee Supreme Court decision under prior law which, although not now applicable, gives some insight with regard to the questions presented. It should be noted that the old statutory terms ". . . customers within Tennessee . . ." are similar to the present statutory terms ". . . purchaser . . . within this state . . .".

Prior law stated that the sales factor of the manufacturer's apportionment formula would consist of "The ratio of the gross sales to customers within Tennessee to total gross sales from all sources." (See T.C.A. § 67-2707 under prior law) In *Woods v. Jack Daniel Distillery*, slip op. S.Ct. (Tenn. April 16, 1977), the Tennessee Supreme Court upheld the Chancellor's ruling that sales destined to purchasers located outside Tennessee should be excluded from the sales factor numerator because earnings from such sales are derived from markets outside Tennessee. The Chancellor had reasoned that it made no difference whether the products sold were transported out of Tennessee by common carrier or by the customer himself. In upholding the Chancellor's decision, the Tennessee Supreme Court said that the word "within" contained in the statute modifies "customers", not "sales", and therefore, the location of the customer determines whether the sale is to an out-of-state customer and is thus excluded from the sales factor numerator.

Today, most states employ UDITPA's "destination test" in determining the attribution of receipts from sales of tangible personal property. Under the destination test, in-state sales are defined as sales with a destination point in that state. Sales delivered to out-of-state purchasers are included in the sales factor of the destination state. W. Raabe and K. Boucher, *Multistate Corporate Tax Guide*, I 413-414 (1994).

The “destination” or “place of market” theory correctly recognizes the contribution of the consumer state to the realization of corporate income. In addition, the “destination test,” as opposed to the “transfer of physical possession” theory, is easy to apply and is not so subject to manipulation by taxpayers. *Strickland v. Patcraft Mills, Inc.*, 302 S.E.2d 544 (Ga. 1983). A taxpayer may be able to structure a delivery or transfer of physical possession in the state that affords the greatest tax savings, but the purchaser’s business location is not likely to be changed solely for the benefit of the seller. *Olympia Brewing*, 326 N.W.2d 642 (Minn. 1982). If physical possession or passage of title were the controlling factor, an out-of-state taxpayer could structure sales transactions with Tennessee customers so that transfer of title or physical possession always occurred outside Tennessee. If this were the case, an out-of-state seller could have Tennessee nexus for franchise, excise tax purposes, and have sales to customers in Tennessee, but have no Tennessee sales to include in the numerator of its apportionment formula sales factor.

CONCLUSION

In all eight (8) of the fact scenario’s presented, the tangible personal property sold is shipped by common carrier from [THE TAXPAYER]’s Tennessee warehouse to [THE TAXPAYER]’s customer at a location outside Tennessee. Under the destination test, or market theory, the F.O.B. point or other conditions of the sale, such as who arranges and pays for shipment, or who is responsible for loss or damage in transit, make no difference. In each fact scenario, the property sold is shipped out-of-state to [THE TAXPAYER]’s customer. Thus the sales are not Tennessee sales for purposes of the corporate franchise, excise tax apportionment formula sales factor numerator.

Arnold B. Clapp, Tax Counsel

APPROVED: _____
Ruth E. Johnson, Commissioner

DATE: July 7, 1995